

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:BRK:TL-N-2247-00
TKerrigan

date:

to: Chief, Examination Branch IV
Attention: Manager Group 1047 - Income
E:E:F:1047

from: District Counsel
Brooklyn CC:NER:BRK

subject: [REDACTED] - Compensation
EIN: [REDACTED]
Taxable years [REDACTED] & [REDACTED]
U.I.L. Nos. 0162.07-01, 0453.00-00

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This memorandum is in response to your request for advice, dated April 6, 2000, concerning the installment sale of the above-named S corporation and deductions claimed for deferred compensation paid the former shareholders.

FACTS

The relevant facts, as we understand them, are as follows: The taxpayer, a subchapter S Corporation, is an insurance broker. At the beginning of the [REDACTED] taxable year there were [REDACTED] shareholders. Two shareholders each owned [REDACTED]% of the corporate stock and the remaining shareholder owned [REDACTED]% of the corporate stock. On [REDACTED], these shareholders entered into an agreement to sell the business to new owners. Both purchasers were employees of the corporation prior to the sale and one was also the son of a [REDACTED]% shareholder. The purchase price for the stock was \$[REDACTED] to be paid in [REDACTED] consecutive annual installments commencing on [REDACTED], together with interest payable monthly on the unpaid principal balance at the rate of

■%. The parties also entered into deferred compensation agreements whereby each former shareholder would receive deferred compensation in the amount of \$■■■■ over a ■■■■ year period. The total deferred compensation expense will be \$■■■■. The payments made to the former shareholders during ■■■■ and ■■■■ were deducted as business expenses on the taxpayer's Forms 1120S, U.S. Income Tax Return for an S Corporation, for the tax years at issue.^{1/}

The revenue agent proposes disallowing the deferred compensation payments for the tax years at issue on the grounds that the taxpayer has failed to establish that the payments were ordinary and necessary expenses. In addition, the revenue agent suspects that the payments may be actually part of the purchase sale price rather than deferred compensation for services rendered by the former shareholders.

The revenue agent examined the former shareholder's individual income tax returns to verify whether the stock sale transaction was properly reported by the sellers. These returns failed to report the stock sale. The taxpayer's accountant represented to the revenue agent that the current shareholders have not yet made any payments pursuant to the stock purchase agreement. The revenue agent has also requested our guidance with respect to the proper method for reporting this transaction by the former shareholders.

ISSUES

1. Whether, under the facts set forth above, the taxpayer is entitled to a I.R.C. § 162 business expenses for deferred compensation paid to its former shareholders?
2. What is the appropriate method for the former shareholders to report the stock sale transaction for Federal income tax purposes?

LEGAL ANALYSIS

1. Deferred Compensation

I.R.C. § 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. I.R.C. § 162(a)(1) provides that deductible expenses include a reasonable allowance for salaries or other compensation for personal services actually

^{1/} The taxpayer claimed deferred compensation expenses in the amount of \$■■■■ in ■■■■ and \$■■■■ in ■■■■.

rendered. See also Rutter v. Commissioner, 853 F.2d 1267, 1270-1271 (5th Cir. 1988), aff'g T.C. Memo. 1986-407; Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1322-1323 (5th Cir. 1987), aff'g T.C. Memo. 1985-267. In the present case, the deferred compensation arrangements involve related parties. Both current shareholders were employees of the taxpayer and one of them is the son of a former shareholder. Accordingly, the salary arrangement requires close audit scrutiny since the transaction may not reflect an arms-length bargain. See Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1243 (9th Cir. 1983), rev'g 40 T.C.M. (CCH) 802 (1980), on remand, 48 T.C.M. (CCH) 1245 (1984), aff'd without opinion, 782 F.2d 1051 (9th Cir. 1986); Standard Asbestos Manufacturing & Insulating Co. v. Commissioner, 276 F.2d 289, 293 (8th Cir. 1960), cert. denied, 364 U.S. 826 (1960); Heil Beauty Supplies Inc. v. Commissioner, 199 F.2d 193, 194 (8th Cir. 1952) [Any compensation arrangement between a closely held corporation and its shareholders is subject to "close scrutiny".]

The taxpayer asserts that the deferred compensation arrangement, which was negotiated in tandem with the stock sale, was in recognition of the many years of substantial and valuable services performed by the former executives, that these executives were underpaid during that period of time and that such arrangements are customary in the industry. These assertions, however, are not supported by the facts developed thus far at the examination level. First, the taxpayer failed to secure an independent compensation survey indicating the officers were under compensated. Second, the taxpayer has provided no information relating to the methodology used to determine the extent of the alleged underpayment. Third, the taxpayer has offered no documents or industry publications demonstrating the prevalence of such arrangements. This information would be necessary in order to properly evaluate whether the deferred compensation payments made are deductible as I.R.C. § 162 ordinary and necessary business expenses.

The current judicial approach with respect to the issue of reasonable compensation is the "independent investor" test. The Ninth Circuit in Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1245 (9th Cir. 1983), rev'g 40 T.C.M. (CCH) 802 (1980), on remand, 48 T.C.M. (CCH) 1245 (1984), aff'd without opinion, 782 F.2d 1051 (9th Cir. 1986) was the first court to consider the reasonableness of compensation "from the perspective of a hypothetical independent investor." Elliotts, Inc. v. Commissioner, 716 F.2d at 1245. The court stated that the appropriate inquiry is whether an inactive, independent investor would be willing to compensate the parties as they were compensated. In ascertaining the answer to this question, the court considered five factors: (1) the role of the employees in the company; (2) salaries paid by similar companies for similar services; (3) the character and condition of the company; (4) any

conflict of interest that might permit the company to disguise nondeductible corporate distributions as salary; and (5) internal consistency, i.e., a reasonable, long-standing, consistently applied compensation plan. Elliotts, Inc. v. Commissioner, 716 F.2d at 1245-1248. The Second Circuit, the circuit to which an appeal would lie if this issue was litigated in Tax Court^{2/}, has followed the Ninth Circuit concluding that "the independent investor test is not a separate autonomous factor: rather, it provides a lens through which the entire analysis should be viewed." Dexsil v. Commissioner, 147 F.3d 96, 101 (2d Cir. 1998), vacating T.C. Memo. 1995-135, on remand, T.C. Memo. 1999-155. See also Rapco v. Commissioner, 85 F.3d 950, 954-955 (2d Cir. 1996), aff'g T.C. Memo. 1995-128.

Applying the "independent investor" analysis to the particular facts and circumstances of this case indicate that further factual development is necessary to properly evaluate the reasonableness of the deferred compensation payments. Our preliminary analysis, which is set forth below, suggests that the amounts claimed may be unreasonable:

(1) Role of the Former Shareholders in the Company

The shareholders, who operated the business for over [REDACTED] years, were named as defendants in a civil fraud litigation instituted by [REDACTED]. In [REDACTED], [REDACTED] commenced a civil action in the United States District Court for the [REDACTED] against the taxpayer and its shareholders for their alleged role in the submission of fraudulent insurance claims under policies written by [REDACTED] between [REDACTED] and [REDACTED]. In [REDACTED], the parties entered into a settlement agreement with respect to the litigation whereby the taxpayer and shareholders agreed to pay the sum of \$[REDACTED] plus interest in full satisfaction of all claims against all defendants for the alleged violations set forth in the complaint.^{3/} [REDACTED] was the major insurer for the clients of the taxpayer. This protracted controversy and the ultimate resolution of this matter resulted in the corporation reporting a loss in the amount of \$[REDACTED] in [REDACTED]. The taxpayer's representative also has stated to the revenue agent that the shareholders retired as a result of these events. The conduct of

^{2/} Under the Golsen rule, the Tax Court will follow the applicable legal precedent of the court of appeals to which an appeal from the decision in the case before it will lie. Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd on other grounds, 445 F.2d 985 (10th Cir. 1971), cert. denied, 404 U.S. 940 (1971).

^{3/} This legal settlement was the subject of a prior advice memorandum, dated [REDACTED].

the former shareholders casts doubt on the reasonableness of any deferred compensation paid to them.

(2) Salaries Paid by Similar Companies

The taxpayer has provided no compensation surveys establishing that the purported deferred compensation is comparable with amounts paid by other insurance brokers.

(3) Character and Condition of the Company

As discussed above, the settlement of the civil lawsuit has negatively impacted the financial condition of the company. Pursuant to the settlement, any funds due the taxpayer from [REDACTED] under a profit sharing agreement are being applied to the outstanding balance due to [REDACTED] until the full settlement amount plus interest is paid. This has had a negative impact on the taxpayer's current gross receipts. We note that the taxpayer reported a loss of \$ [REDACTED] in [REDACTED].

(4) Conflict of Interest

The new owners and former shareholders had a prior employee/employer relationship. This close relationship may have distorted the structure of the transaction to the benefit of the former shareholders. We also note that the new shareholders failed to employ an outside compensation consultant to determine whether deferred compensation was appropriate in this instance or an independent appraiser to ascertain the fair market value of the business.

(5) Internal Consistency

The deferred compensation payments were negotiated as part of the sale of the business. The taxpayer has provided no information that the purported payments are part of a consistently applied compensation plan.

The taxpayer also points to the fact that each former shareholder receives the same amount of deferred compensation, rather than prorated payments based on the stock ownership interest, as establishing that such payments are not part of a disguised sale price. We note that the structure of the deferred compensation arrangement would likely make it difficult for the Service to recharacterize the compensatory payments as part of the purchase price for the corporate stock. This fact, standing alone, however, does not establish that the deferred compensation amounts are reasonable and deductible by the taxpayer. Furthermore, the Service may also be able to argue that these payments were made as an inducement to consummate the sale rather than compensation for past services. I.R.C. § 162(a)(1) requires

that the payments at issue are for services actually rendered. In order for the deferred compensation payments to qualify as compensation for services rendered, the taxpayer must establish the fact and amount of the underpayment from the prior years. American Foundry v. Commissioner, 536 F.2d 289, 293 (9th Cir. 1976). In the present case, if the payments at issue were part of the consideration for the stock purchase transaction, these payments would not satisfy the statutory requirement of I.R.C. § 162(a)(1) that the payments are made for services "actually rendered". This alternative "disguised sale price" argument would be more persuasive if the revenue agent can establish that the appraised value of the business at the time of the sale was considerably higher than the stated sales price.

2. Stock Sale

In general, a sale of stock gives rise to a realization event for tax purposes requiring immediate recognition of gain or loss. Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991); United States v. Centennial Savings Bank, 499 U.S. 573 (1991); I.R.C. § 1001(c). I.R.C. § 453(a), however, provides that income from a qualifying installment sale shall be reported under the "installment method". An installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. I.R.C. § 453(b)(1).

The facts of this case indicate a disposition of property by the former shareholders with payments to be received in subsequent years and can be characterized as an installment sale under I.R.C. § 453. Therefore, the former shareholders are entitled to installment method accounting when payments are received with respect to the sale. It is our understanding that the new shareholders have not made any principal payments under the terms of the agreement but have made the required interest payments on the stock purchase obligations. Therefore, we recommend that you verify that the former shareholders are properly reporting all interest income received. When principal payments are received, each payment received is treated in part as (1) a nontaxable recovery of a portion of the former shareholder's basis and (2) a taxable realization of a portion of the seller's gain. See I.R.C. § 453(c).

CONCLUSION

Based on the above, we recommend that the revenue agent secure the assistance from the District of a staff economist or engineer for purposes of determining both the valuation of the corporation at the time of the sale and the reasonableness of the deferred compensation payments. This technical assistance will assist the revenue agent in adequately developing the reasonable

compensation issue and the related disguised sales price issue raised in the advice request.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures, which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

If you have any questions or require further assistance, please contact Thomas Kerrigan at (516) 688-1742.

JODY TANCER
Acting District Counsel